STATE OF CALFORNIA
ELECTRICITY OVERSIGHT BOARD

Gray Davis, Governor

January 15, 2002

VIA UPS NEXT DAY AIR

Hon. Linwood A. Watson, Jr., Acting Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, D.C. 20426

Re: California Electricity Oversight Board v. Williams Energy Services Corporation, et al.
Docket No. EL02- _____-000

Dear Mr. Watson:

Enclosed for filing are one original and 15 copies of the California Electricity Oversight Board's ("Board") Complaint. Please file endorse the extra copy and return it to me in the enclosed self-addressed stamped envelope. **The Board further requests privileged treatment, pursuant to 18 C.F.R. § 388.112, of Exhibit A attached to the Complaint on the ground that the information is potentially confidential under the terms of the CAISO Tariff.** Inquires regarding the privileged status of Exhibit A may contact the undersigned.

I also enclose a 3 ½ inch diskette in ASCII format, which contains a form of notice suitable for publication in the *Federal Register* as required by Rule 206(b)(10). 18 C.F.R. § 206(b)(10).

Thank you for your assistance.

Sincerely,

Grant A. Rosenblum
Staff Counsel
Electricity Oversight Board

Enclosures
cc: Official Service List of EL00-95-000

tel 916.322-8601 770 L St., Suite 1250, Sacramento, CA 95814 fax 916.322-8591

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Electricity Oversight Board, Complainant v. Williams Energy Services Corporation, AES Huntington Beach LLC, AES Alamitos LLC, AES Redondo Beach LLC, Mirant Americas Energy Marketing L.P., Mirant Delta LLC, Reliant Energy Services, Inc., Reliant Energy Coolwater LLC, Reliant Energy Etiwanda LLC, Reliant Energy Mandalay LLC, Reliant Energy Ormand Beach LLC, Dynegy Power Marketing, Inc., Encina Power LLC, Calpine Corporation, Geysers Power Company LLC, Southern California Edison Company, All Other Public and Non-Public Utilities Who Own or Control Generation in California And Who Sell Through the Markets or Use The Transmission Lines Operated by the California Independent System Operator Corporation, and All Scheduling Coordinators Acting on Behalf Of the Above Entities, Respondents	)	Docket No. EL02-____-000

COMPLAINT REQUESTING AN IMMEDIATE CEASE AND DESIST ORDER AND EXPANSION OF "MUST-OFFER" REQUIREMENT OR, IN THE ALTERNATIVE, AN EVIDENTIARY HEARING WITH FAST-TRACK PROCESSING

Pursuant to Section 206 of the Federal Power Act, 16 U.S.C. § 824e, and Rule 206 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.206, the California Electricity Oversight Board (California Board) hereby files this Complaint to remedy ongoing and pervasive violations of the Federal Power Act accomplished through anti-competitive price bids for "decremental energy" in the real time energy market administered by the California Independent System Operator Corporation (CAISO).

I.

SUMMARY OF COMPLAINT

The CAISO, and all other transmission system operators, must possess the capability to increase as well as decrease generation levels in real time to manage system energy imbalances. The ability to adjust output allows the CAISO to follow changing load, address forecast errors, and remedy local reliability or congestion concerns. Under the CAISO Tariff, if a real time energy imbalance exists, resources are dispatched to adjust energy output up or down by calling on bids submitted into the CAISO's Balancing Energy Ex-Post Price (BEEP) auction market.[1] Bids into the CAISO real time market to produce more energy are called "incremental bids" or "inc" and bids to reduce energy output are called "decremental" or "dec" bids. Only when the amount or operational characteristics of the energy bid into BEEP stack are insufficient to remedy the threat to reliability can the CAISO issue dispatch instructions directing any Participating Generator to change its output.

[1] See CAISO Tariff §§ 2.5.22.5, 2.5.22.2 and Dispatch Protocol § 8.6.3. The BEEP stack represents various resources, such as adjustment and supplemental energy bids, and, unless specifically limited by election of the generator, energy from capacity that is selected in the ancillary services markets.

Decremental energy bids generally represent the price generators are willing to pay to reduce their output in the CAISO's real time market. In a competitive market, a supplier should be willing to pay a price to reduce generation at a price at or just below its variable costs of production.[2] However, California's real time energy markets are not competitive and the Commission has responded by imposing a mitigation strategy that includes, most notably in the present context, a requirement for all in-state non-hydro generating units to bid all *available* capacity into the CAISO's real time market subject to a price cap during non-reserve deficiency hours.

Unfortunately, a gap exists in the Commission's mitigation plan and gaming continues. One unchecked game is suppliers' submission of anti-competitive decremental energy bids, i.e., bids at prices far below the resource's variable cost of production. In fact, market participants, including respondents, have submitted, and continue to submit, *negative* decremental bids which the CAISO must often accept. Negative decremental bids are bids for the CAISO to *pay the generator not to produce* energy which the supplier sold. Since the supplier already sold the energy, it will be compensated by its buyer whether or not the CAISO reduces the supplier's output. Thus, paying the supplier to reduce output results in excess profits that would not be realized in a competitive market.

The unjust and unreasonable bidding behavior of multiple market participants into the CAISO's decremental energy real time market exposes the harmful gap in the Commission's current mitigation plan and confirms that market power continues to taint California's wholesale electric markets. The California Board, therefore, requests the

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[2] For most types of generating units, and certainly for gas-fired units, the variable cost of production is positive. As such, bids at or near avoided costs will be positive, i.e., offers to pay the CAISO to reduce

Commission issue an order immediately prohibiting anti-competitive decremental energy bids and expanding the "must-offer" obligation adopted by the Commission in *San Diego Gas & Electric Company, et al.,* 95 FERC ¶ 61,418 (2001) ("July 19 Order") to include a requirement that all suppliers with a Participating Generator Agreement and scheduled to run submit decremental bids based on avoided cost methodology.[3] In the alternative, if the Commission does not issue the requested order immediately, the California Board requests that the Commission establish an evidentiary hearing, with fast-track processing, to expedite resolution of the issues raised herein and set the earliest allowable refund effective date.

II.

COMMUNICATIONS AND COMPLAINANT DESCRIPTION

The Board is an agency of the State of California and was created as a component of California's comprehensive electric industry restructuring legislation. The Board's statutory responsibilities include oversight of the California Independent System Operator Corporation ("CAISO"), the energy and ancillary services markets administered by the CAISO, and the reliability of the CAISO-controlled electricity grid.

The principal office of the Board is located at 770 L Street, Suite 1250, Sacramento, California, 95814. All pleadings, orders, correspondence and communications regarding this motion should be directed to the following persons:

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output.

[3] The California Board names as respondents in this Complaint not only those actual entities engaged in unjust and unreasonable bidding behavior, but also all other public and non-public utilities who own or control generation in California and who sell through the markets or use the transmission lines operated by the California Independent System Operator Corporation. Thus, the scope of respondents in this Complaint is intended to be coextensive with those entities subject to the July 19 Order's must-offer requirement.

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III.

NEGATIVE DECREMENTAL ENERGY BIDS RESULT IN UNJUST AND UNREASONABLE RATES

A. The Federal Power Act Prohibits Anti-Competitive Bidding Behavior

The Commission has the obligation, and possesses the authority, to rectify anti-competitive bidding practices in electricity wholesale markets. Section 205(a) of the FPA requires that all rates or charges demanded by a public utility in connection with the sale of electric energy "shall be just and reasonable."[4] Any rate or charge that is not just and reasonable is "unlawful" and subject to remediation by the Commission.[5] Section 309 of the FPA further grants the Commission the power to "perform any and all acts," and to issue such rules and orders "necessary and appropriate" to carry out the provisions of the FPA.[6] Indeed, the Commission recently exercised its authority to prohibit anti-competitive bidding behavior and clarified that such bidding can trigger refund liability and the imposition of further conditions or restrictions on public utility sellers' market based rates.[7] Consistent with its authority, the Commission should take immediate action here with respect to the CAISO's real time decremental energy market.

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4 16 U.S.C. § 824d(a).
5 *Id.;* 16 U.S.C. § 824e(a).
6 16 U.S. C. § 824h.
7 *San Diego Gas & Electric Company, et al.*, 95 FERC ¶ 61,115 (2001) at 61,360; see also, *Order Establishing Refund Effective Date and Proposing to Revise Market-Based Rate Tariffs and Authorizations,* 97 FERC ¶ 61,220 (2001).

B. Negative Decremental Bids Lack Any Economic Justification Except to Create Windfall Profits For Suppliers

The Commission has repeatedly found that the CAISO's real time electricity market, which encompasses the market for decremental and incremental energy, was, and remains, insufficiently competitive to allow wholly unrestricted market based rates. In this regard, the Commission staff concluded the CAISO markets exhibited "actual market power effects" as manifested in suppliers' practice of bidding above marginal cost.[8] The Commission echoed staff's assessment by concluding that the electric market structure and market rules for wholesale sales of electric energy in California are "seriously flawed" and have caused, and have the potential to continue to cause, "unjust and unreasonable rates for short-term energy…"[9]

In response to the exorbitant and unlawful wholesale electric rates in California, the Commission implemented a market mitigation strategy that includes, among other elements, a "must-offer" selling obligation and a price cap on real time energy sales. The must-offer obligation compels all non-hydroelectric generators, including non-public utility generators, in California to offer the CAISO all of their capacity in real-time during all hours if it is available and not scheduled to run.[10] In other words, the must-offer obligation requires suppliers to submit incremental energy (available capacity) bids into the CAISO's real-time imbalance energy market.[11] Thus, the must-offer requirement provides a mechanism to reduce the exercise of market power in the form of

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[8] *Staff Report to the Federal Energy Regulatory Commission on Western Markets and Causes of the Summer 2000 Price Abnormalities*, Docket Nos. EL00-95-000, et al. (Nov. 1, 2000).

[9] *San Diego Gas & Electric Company, et al.*, 93 FERC ¶ 61,121 (2000) at 61,349; *San Diego Gas & Electric Company, et al.*, 93 FERC ¶ 61, 294 (2000) at 61,984.

[10] July 19 Order, slip. op. at 15.

[11] To the extent generator with a gas-fired unit subject to the must-offer requirement fails to submit a bid for all or part of its available capacity, the CAISO uses a "proxy price" based on the real-time price

physical withholding with respect to incremental bids by broadening and deepening the market for additional generation. The price cap limits economic withholding of incremental energy. Regrettably, neither mitigation measure does anything to prevent gaming, and resulting windfall profits, in the decremental energy market.

Generators have and are exploiting the gap in the Commission's mitigation plan by exercising market power in the decremental energy market. Generators are doing so by submitting anti-competitive decremental bids. In a well-functioning market, there should be competition among suppliers resulting in *positive* decremental bids that closely track a producer's avoided costs.[12] For example, suppose a supplier incurs operating costs of $30 an hour. That supplier should be bidding close to $30 (i.e. willing to pay $30) for not generating in any particular hour. If the suppler has sold its energy for $35 per hour, the supplier is assured its $5 profit and may increase its profit margin if the clearing price for decremental energy is less than $30.

Within the structure of the CAISO real time market, the unjust and unreasonable effect of anti-competitive decremental bids becomes obvious. Suppose that same supplier with costs of $30 per hour sold energy for $35 per hour, but submits a decremental bid of -$30. If the -$30 clears the market, the supplier will be paid $35 from the buyer (just as in the example above), will incur zero running costs for that hour *and* be paid an additional $30 for a total profit of at least $60. The Commission's current

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mitigation formula. (CAISO Compliance Filing, *San Diego Gas & Electric Company, et al.*, Docket No. El00-95, et al. (May 11, 2001), p. 5.)

[12] As the Commission itself has stated: "In a competitive situation, a generator would set its bid at the level of the costs that it can avoid by not generating. Because each generator has been paid the market clearing price for its commitment to operate in real-time, each generator would be indifferent to operating and incurring running cost, or not operating and paying the ISO an amount equal to its running cost." (*Order Accepting for Filing in Part and Rejecting in Part Proposed Tariff Amendment and Directing Reevaluation of Approach to Addressing Intrazonal Congestion,* 90 FERC ¶ 61,006 (2000) ("Intrazonal Congestion Order"), at 61,012, *reh'g denied* 91 FERC ¶ 61,026 (2000).)

market mitigation measures do not prohibit this obvious market abuse. As a result, anti-competitive decremental energy bidding is unchecked. For instance, as set forth in Exhibit A[13] filed herewith, for the period September 1 – December 31, 2001, one gas-fired generator submitted negative decremental energy bids in approximately 60% of the CAISO 10 minute dispatch intervals, covering 183,257 MW at an average price of -$42.44.

Anti-competitive decremental bidding reflects continued efforts by suppliers to take advantage of California's dysfunctional market structures as well as infrastructure constraints. The presence of intra-zonal congestion facilitates the profitability of anti-competitive decremental bids. Intra-zonal congestion refers to transmission congestion that occurs within a particular congestion zone. Unlike inter-zonal congestion, which refers to congestion across congestion zones, i.e., Path 15, the CAISO currently does not have a process to alleviate intra-zonal congestion in the forward market.[14] Instead, the CAISO mitigates intra-zonal congestion in real-time and pays each supplier "as bid." The limited geographic area of the congestion limits the number of resources capable of relieving the constraint. The result is local market power. The CAISO has observed an

13 The California Board requests confidential treatment of Exhibit A pursuant to 18 C.F.R. § 388.112. It should be noted that Exhibit A only sets forth negative decremental bids and, therefore, understates the number and volume of anticompetitive decremental bids by excluding positive bids that nevertheless do not reflect the unit's marginal costs.

14 The Commission in the Intrazonal Congestion Order recognized that "the existing congestion management method [of the CAISO] is flawed and needs to be overhauled or replaced." (90 FERC ¶ at 61,013.) Accordingly, the Commission ordered the CAISO to review its mechanism for intrazonal congestion approach and design a comprehensive replacement plan. (*Id.*, at 61,013 and 61,016.) Unfortunately, the exigencies of the California energy crisis consumed the CAISO's limited resources and prevented the CAISO from submitting such a comprehensive plan. The CAISO's delay, however, does not obviate the Commission's responsibility to ensure just and reasonable market rates.

The Board further recognizes that the CAISO has published a "Preliminary Draft Comprehensive Design Proposal" for stakeholder comment. (See, http://www.caiso.com/docs/09003a6080/13/58/09003a6080135879.pdf) It is anticipated that the elements of such plan will not be implemented until September 30, 2002, at the very earliest. This complaint and the increase in "localized market power events" involving "large negative decremental energy bids" to reduce scheduled output.[15]

The Commission has, therefore, left a gap open for gaming the CAISO's decremental energy market. Suppliers have taken advantage by exercising market power through anti-competitive, unjust and unreasonable negative decremental bids. The FPA imposes upon the Commission an affirmative obligation to close that gap.

C. The Commission Must Immediately Prohibit Anti-Competitive Decremental Bids and Impose a Must-Offer Requirement on the CAISO's Decremental Energy Market.

To address the ongoing violations of the FPA, the California Board respectfully requests an immediate cease and desist order prohibiting further anti-competitive bids into the CAISO's real time decremental energy market. In addition, the California Board requests that the Commission mitigate the exercise of market power in the decremental energy market by imposing a symmetrical must-offer requirement. Such a requirement should require that all suppliers with resources scheduled in the CAISO's day-ahead or hour-ahead markets must submit unit-specific cost-based proxy decremental energy bids in volumes equivalent to the difference between the scheduled generation and the units' minimum load capacity. Unlike the incremental bid must-offer requirement which must address operational constraints and characteristics, a must-offer requirement for decremental energy should not be problematic because the units are already operating in real time.

relief requested is intended to mitigate market power abuses in the decremental energy market until implementation of a permanent market redesign solution can be implemented.

[15] CAISO Market Analysis Report for October 2001 (Nov. 19, 2001) at pp. 13-14, http://www.caiso.com/docs/09003a6080/11/9c/09003a6080119c72.pdf

IV.

ADDITIONAL INFORMATION TO COMPLY WITH RULE 206

The following information is submitted in compliance with the requirements of Rule 206(b) of the Commission's Rules of Practice and Procedure.[16]

Rule 206(b)(1)-(2): Clearly identify the action or inaction which is alleged to violate applicable statutory standards or regulatory requirements; explain why the action or inaction violates applicable statutory standards or regulatory requirements.

These matters are set forth at pages 1-8, but generally relate to negative bids for decremental energy which have no economic justification and, therefore, constitute an exercise of market power resulting in unjust and unreasonable rates.

Rule 206(b)(3): Set forth the business, commercial, economic or other issues presented by the actions or inaction as such relate to or affect the complainant.

The California Board does not have any direct business, commercial or economic interests affected by the actions or inaction alleged herein. Rather, the California Board's interest arises from its statutory mandate to oversee the CAISO and the markets it operates on behalf of the State of California.

Rule 206(b)(4): Make a good faith effort to quantify the financial impact or burden (if any) created for the complainant as a result of the action or inaction.

See answer to Rule 206(b)(3).

Rule 206(b)(5): Indicate the practical, operational, or other nonfinancial impacts imposed as a result of the action or inaction, including, where applicable, the environmental, safety or reliability impacts of the action or inaction.

These matters are set forth at pages 1-8.

[16] 18 C.F.R. § 385.206(b).

Rule 206(b)(6): State whether the issues presented are pending in an existing Commission proceeding or a proceeding in any other forum in which the complainant is a party, and, if so, provide an explanation why timely resolution cannot be achieved in that forum.

The specific issues and conduct underlying the Complaint are not the subject of pending Commission proceedings. However, allegations relating to market power, unjust and unreasonable prices in the CAISO's real time market, and measures to mitigate uncompetitive behavior in California are the subject of Docket Nos. EL00-95, et al. In particular, issues relating to the propriety and implementation of the "must-offer" requirement are subject to pending requests for rehearing of the July 19 Order. Nevertheless, while the California Board believes it has submitted sufficient evidence to support an immediate order of the Commission, the California Board raises the issues herein as an independent complaint, rather than as a motion in Docket Nos. EL00-95, et al., to facilitate, if necessary, the initiation of an evidentiary hearing. Further, the California Board has filed this Complaint separately from existing proceedings to ensure a discrete record should the California Board be required to pursue a legal action in court to protect its interests and those of the State of California.

Rule 206(b)(7): State the specific relief or remedy requested.

The specific relief sought is addressed on page 8.

Rule 206(b)(8): Include all documents that support the facts in the complaint in possession of, or otherwise attainable by, the complainant, including, but not limited to, contracts, affidavits and testimony.

The California Board has provided citations, and, where appropriate and available, supporting exhibits. The California Board can provide the bid data used to generate Exhibit A attached hereto if it will assist the Commission's determination.

Rule 206(b)(9): State (i) whether the Enforcement Hotline, Dispute Resolution Service, Tariff-based dispute resolution mechanisms, or other informal procedures were used; (ii) whether the complainant believes that alternative dispute resolution (ADR) under the Commission's supervision could successfully resolve the complaint; (iii) what types of ADR procedures could be used; and (iv) any process that has been agreed on for resolving the complaint.

The California Board has not utilized any of the Commission's alternative dispute resolution (ADR) services described in Rule 206(b)(9) and believes that the nature of this complaint is such that ADR may not be useful. The California Board is informed that the CAISO has informally raised the issues herein to the suppliers directly and, while some suppliers have moderated their bidding behavior, such changes are not to a level deemed "acceptable" to the CAISO.[17] The subject matter of the complaint, coupled with the need for immediate Commission action to mitigate structural aspects of the CAISO's market, would likely render ADR-type procedures ineffective and inefficient.

Rule 206(b)(10): Include a form of notice suitable for publication in the *Federal Register* and submit a copy of the notice on a separate 3 ½ inch diskette in ASCII format.

A form of notice, in paper and electronic form, is attached to the complaint.

Rule 206(b)(11): Explain with respect to requests for Fast Track Processing pursuant to Section 385.206(h), why the standard process will not be adequate for expeditiously resolving the complaint.

Without immediate Commission action, market power will continue to be exercised in the CAISO real-time market resulting in the unjust enrichment of electric energy suppliers at the expense of California consumers.

V.

CONCLUSION

WHEREFORE, the California Board requests a finding that the practice of negative decremental bidding into the CAISO's real time market is unjust and unreasonable bidding behavior and an unlawful exercise of market power under the FPA. The California Board further requests the Commission issue an order immediately (1) prohibiting anti-competitive negative decremental energy bids and (2) expanding or adopting a "must-offer" to include decremental bids as described above. In the alternative, if the Commission does not issue the requested order, the California Board requests that the Commission establish an evidentiary hearing, with fast-track processing, to expedite resolution of the issues raised herein and set the refund effective date sixty days from the filing of this Complaint.

Dated: January 15, 2002

Respectfully submitted,

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Sidney M. Jubien, Senior Staff Counsel
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[17] CAISO Market Analysis Report for October 2001 (Nov. 19, 2001) at p. 14, http://www.caiso.com/docs/09003a6080/11/9c/09003a6080119c72.pdf

CERTIFICATE OF SERVICE

I hereby certify that I have caused the foregoing document to be served upon each person designated on the official service list compiled by the Secretary for this proceeding on or before January 16, 2002, pursuant to Rule 2010(a) of the Commission's Rules of Practice and Procedure.

Dated at Sacramento, California, this 15th day of January, 2002.

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